No. 13672.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

HARRY J. COFFMAN,

Appellant,

vs.

COBRA MANUFACTURING COMPANY,

Appellee.

ANSWERING BRIEF OF APPELLEE.

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Introductory Statement.

This is a supplemental proceeding in aid of judgment and execution under Rule 69 of the Federal Rules of Civil Procedure and Sections 714 to 721, inclusive, of the California Code of Civil Procedure which have been adopted by reference in Federal Rule 69 as the proper and appropriate procedure in aid of judgments and executions. Under Federal Rule 69(a) the local state law is the controlling rule as to both the substantive and procedural rights of the parties, as declared by the authorities cited in the footnote below.*

**Huddleston v. Dwyer*, 322 U. S. 232, 64 S. Ct. 1015, 88 L. Ed. 1246; *De Foe v. Town of Rutherfordton* (C. C. A. 4), 122 F. 2d 342; *Schram v. Carlucci* (D. C. Mich.), 41 Fed. Supp. 36; *Keering v. Wishnefsky* (N. Y.), 52 Fed. Supp. 625, affirmed in 142 F. 2d 1005; *Fidelity Union Trust Co. v. Field*, 61 S. Ct. 176, 311 U. S. 169, 85 L. Ed. 109; *Capital Co. v. Fox*, 85 F. 2d 97, 106 A. L. R. 376; *Ex parte Boyd*, 105 U. S. 647, 26 L. Ed. 1200; *Schram v. Spivack*, 68 Fed. Supp. 451.

Supplementary proceedings are a substitute for creditors' bills as formerly used in Chancery, and they are equitable in nature.

Herrlich v. Kaufman, 99 Cal. 271;

Travis Glass Co. v. Ibbetson, 186 Cal. 724;

Philips v. Price, 153 Cal. 146;

Parker v. Page, 38 Cal. 522;

McClutcheon v. Superior Court, 134 Cal. App. 5;

Tucker v. Fontes, 70 Cal. App. 2d 768;

Medical Finance Assn. v. Karnes, 32 Cal. App. 2d 767;

Bunnell v. Winns, 13 Cal. App. 2d 114;

Finch v. Finch, 12 Cal. App. 274.

The Special Master who conducted the examination in the instant supplementary proceeding was the trier of the factual issues, and unless clearly erroneous his findings are binding on the reviewing court. As stated in the leading case of *Parker v. Page,* 38 Cal. 522, the California Supreme Court in construing Section 244, the predecessor of Section 719 of the present Code of Civil Procedure, declared at page 525 as follows:

> ". . . Counsel for the garnishee insist that, under Section 244, when it is alleged that the garnishee is indebted to the judgment debtor, or has in his hands property belonging to him, if the fact is denied, the only order which the Court can properly make is one authorizing the judgment creditor to institute an action against the garnishee, in order to adjudicate the disputed fact in a proceeding having all the necessary parties before the Court. *This is undoubtedly true, if the denial be made in good faith.*

> The obvious purpose of Section 244 was to entitle the garnishee, *who in good faith*, denied that he had any property of the judgment debtor, or was in any wise indebted to him, to the benefit of a trial in a regular action with the proper parties, and before a jury in a proper case. . . . It may be that the referee deemed the testimony of the garnishee on this point so evasive as to discredit it; and when it is evident that the garnishee is acting *in bad faith in denying his indebtedness to the judgment debtor, and makes the denial only in form and for purposes of vexation and delay, the referee may* TREAT IT AS FRAUDULENT, AND DISREGARD IT. *The denial of the debt or the adverse claim to the property, contemplated in Section 244, is a claim or denial in good faith, and not a mere fraudulent sham, resorted to for purposes of delay.* To permit a fraudulent garnishee for the mere purpose of delay, and who, evidently, is acting in bad faith, to avail himself of Section 244, in order to drive the judgment creditor to an action against him, would be to pervert the true purpose of that section, and make it a shield for fraud, instead of an instrument of justice." (Emphasis ours.)

In the recent case of *Heath v. Helmick,* 173 F. 2d 157, this Court stated as follows:

> "The badges of fraud with relation to creditors were early marked in the English mercantile community. Because of the pattern which such action took, the more notorious were denounced in the earliest enactments culminating in the statutes of Elizabeth. In general, as here action of a debtor attempting to defraud creditors will be found catalogued and indexed in Coke in what has been called his restatement of the law. Twyne's Case is a classic

which delineates many devious devices. These medieval authorities are not cited as binding precedents, but to show that the propensities of the human heart bent on fraud are almost standard. Yesterday, today, and tomorrow, the same tortuous trail can be followed by the same blazes." (At pp. 160-161.)

"There is a suggestion that the referee was not justified in finding fraud. It is said that, whether the inference can be drawn from certain evidence is a question of law. But the trier of fact, who sees the witnesses is free to disbelieve them even if there is no flat contradiction. . . . In any event, this court would be constrained to support the findings of a referee who saw the witnesses, where these are fully supported by the record and are concurred in by the trial court on review." (At pp. 161-162.)

Appellee, Cobra Manufacturing Company, is a California corporation and is the judgment creditor of the California Aircraft Engineering Company, a corporation, and appellant Harry J. Coffman was the majority stockholder, director, president, and the sole manager of the debtor corporation, during the period in question. For sake of brevity the judgment creditor is called herein COBRA and the judgment debtor is called AIRCRAFT.

Nature of Action.

The present controversy between Cobra and appellant Coffman arises out of the bankruptcy matter initiated by Cobra in the court below by filing a petition under Chapter XI of the Bankruptcy Act which resulted in the judgment in favor of Cobra against Aircraft in the sum of $6,254.25.

Prejudgment Proceedings in the Bankruptcy Matter.

The following proceedings relevant on this appeal were had in said bankruptcy matter:

1. Cobra's petition for arrangement under Chapter XI of the Bankruptcy Act was filed in March, 1946, and thereupon the matter was referred to Honorable Hugh L. Dickson, one of the referees in bankruptcy of the District Court for the Southern District of California, Central Division.

2. Aircraft, a creditor of Cobra, made and filed in said bankruptcy matter a verified proof of claim against Cobra in the sum of $1,868.16, which claim was objected to by Cobra, and Cobra thereupon filed a counterclaim and set-off against Aircraft in the sum of $6,254.25. The respective claims of the parties involved mutual debts and credits under Section 68 of the Bankruptcy Act, based on their mutual transactions from May 7, 1945, and April 16, 1946 [R. p. 5].

3. There was a hearing before the Referee on the merits on said mutual debts and credits to which no objection was interposed either by Aircraft or appellant Coffman. At the conclusion of the hearing the Referee made findings of fact and conclusions of law and signed an order awarding to Cobra its set-off in the sum of $6,254.25. The order, signed and filed by the Referee on May 20, 1947, was affirmed by the District Judge on Aircraft's petition for review under Section 39(c) of the Bankruptcy Act on November 5, 1947.

4. The aforesaid order of the District Judge was entered in the Civil Docket of the court in Book 46 of Judgments, at page 696 [R. p. 4]. No motion for relief from said judgment was ever made either by Aircraft or

Coffman under Rule 60 of the Federal Rules of Civil Procedure; nor was said judgment appealed from, and the judgment was final.

5. The bankruptcy matter was closed on September 14, 1948, and an order was entered by the Referee closing said bankruptcy matter and the revesting of all of the remaining assets in Cobra, which included the aforesaid judgment [R. p. 24].

6. On the basis of said judgment an execution was issued on July 6, 1950, against Aircraft [R. pp. 25-26], which was returned unsatisfied on September 12, 1950 [R. p. 27].

Proceedings After Entry of Judgment.

Based on the affidavit of Cobra made pursuant to Section 715 of the California Code of Civil Procedure, an order was made by the District Judge directing Aircraft and Coffman to submit to an examination relating to the disposition and disappearance of Aircraft's property and assets, and appointing and directing the Honorable Howard V. Calverley, the United States Commissioner of the Federal District Court, as Special Master to conduct said examination, and to make findings of fact and conclusions of law in respect thereto. The order further provided as follows:

> "That the powers of said Special Master shall be coextensive with the powers of this Court, as if the examination was had by this Court. . . . That said Master shall have all such powers as are conferred on Masters by the rules of Civil Procedure for the District Courts of the United States."

Said order was duly served on Aircraft and Coffman and in response thereto Coffman appeared before the

Master on August 10, 1950, and at his request the examination was continued to August 24, 1950, in order to enable him to obtain counsel to represent him at the examination. Several hearings were thereafter had before the Master, at which Coffman was represented by counsel. The matter was heard on the merits without an objection being interposed by Coffman or his counsel. The hearing was concluded on June 28, 1951 [R. p. 48]. On October 16, 1951, the Special Master filed his report and findings in which he found as a fact that Coffman was the controlling stockholder, director and president of Aircraft during the period in question, and that he had misappropriated the Aircraft funds in fraud of Aircraft's creditors. The Master found as a fact that said misappropriation by Coffman took place between May 1, 1945, to and including June 30, 1948, that said misappropriation was wrongful, and in breach of his trust, that Coffman did thereby cause the financial inability of Aircraft to pay the aforesaid judgment, and that Coffman was indebted to Aircraft in the sum of $9,240.46. The Master further found:

> "Harry J. Coffman does not deny, *in good faith,* that he is in debt to the California Aircraft Engineering Company, a California corporation, in the sum of $9,240.46. . . . the Master concludes that either upon the theory of debt, or breach of a constructive trust, which theories are not mutually exclusive, Harry J. Coffman should be ordered by the District Court to pay to the Cobra Manufacturing Company, a corporation, the sum of $6,254.25, the amount of the judgment which the Cobra Manufacturing Company has obtained against the California Aircraft Engineering Company, together with interest at the rate of 6% from the date of judgment, namely, November 5, 1947, and costs."

Said report was excepted to by Coffman, and upon the hearing of his exceptions, and on Coffman's application, a *stipulated order of re-reference* was made and entered by the District Judge to the Master for a factual finding and conclusion of law in respect to Coffman's claimed offset against Aircraft in the sum of $12,207.39. At said hearing Coffman admitted that he was indebted to Aircraft in the sum of $9,240.46, but claimed he was entitled to an offset in the sum of $12,207.39.

Pursuant to said order of re-reference the Master made a supplemental factual finding and a conclusion of law, and the Master found as a fact and as a matter of law that Coffman was not entitled to his said offset. The Master further found as a fact that Coffman's denial of his indebtedness to Aircraft *was not made in good faith.* In his said supplemental report the Master made additional subsidiary findings which present a cogent appraisal and analysis of all of the evidence, and conclusively demonstrated that Coffman's alleged offset was a mere bookkeeping entry, not entitled to credence [Supp. Report, R. beginning at p. 81].

Said supplemental report was excepted to by Coffman, and his exceptions were based on the sole ground that the Master's Subsidiary Findings were not supported by the evidence, no objection being interposed to the jurisdiction of the Master to make a factual finding on his alleged offset [R. p. 96].

A minute order was entered by the District Judge on August 14, 1952, adopting and approving the Master's original and supplemental reports, and ordering the parties to submit a formal order to this effect [R. p. 102].

Thereafter, on August 22, 1952, Coffman filed a motion for leave to reargue his aforesaid objections and to have the Court reconsider its ruling. Said motion was based on the sole ground that Coffman was entitled to his aforesaid offset against Aircraft in amount $12,-207.39, that the Master's factual finding on this issue was erroneous, *and that for this reason* the *Master was divested of jurisdiction to hear the matter* [R. 103, 104]. Said motion was denied by the District Judge on September 8, 1952 [R. p. 119].

Following the denial of said motion, a written formal order was signed and filed by the District Judge on October 27, 1952, adopting and approving the Master's original and supplemental reports and overruling Coffman's exceptions. The order made the finding that Coffman was the majority stockholder, director and president of Aircraft, and that:

> "II. Pursuant to the recommendation of the Special Master, which is adopted and accepted by the Court and in accordance with the provisions of Section 719 of the California Code of Civil Procedure, which has been adopted by reference in Rule 69(a) of the Federal Rules of Civil Procedure, Harry J. Coffman is ordered to pay to the judgment creditor, Cobra Manufacturing Company, the sum of $6,-254.25, the amount of the judgment which the Cobra Manufacturing Company has obtained against the California Aircraft Engineering Co., the judgment debtor herein, on November 5, 1947, entered in Book 46 of Judgments of this Court at page 696, together with interest at the rate of 6% from November 5, 1947, and costs. (Costs taxed at $221.43.)" [R. 123.]

Jurisdictional Statement.

I. The jurisdiction of the District Court is based on the following:

(1) Section 68 of the Bankruptcy Act provides that, "In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid."

(2) Under Rule 54 of the Federal Rules of Civil Procedure "judgment" includes "a decree and any *order* from which an appeal lies."

(3) Rule 79 of the Federal Rules of Civil Procedure provides for the keeping by the Clerk of a civil docket, and requires the Clerk to make entries therein of judgments *and appealable orders.*

(4) Under Rule 60 of the Federal Rules of Civil Procedure the Court may relieve a party from a final judgment, *order,* or proceeding, provided that a motion therefor is made within a reasonable time.

(5) Rule 53 of the Federal Rules of Civil Procedure provides for the appointment of masters and prescribes their duties and powers, and requires him to make findings of fact and conclusions of law if the order of reference so states. It also provides that an "Application to the court for action upon the report *and upon objections* thereto shall be by motion, etc."

(6) Rule 69 of the Federal Rules of Civil Procedure covers supplementary proceedings in aid of judgment and executions, and provides that such proceedings shall be "in accordance with the practice and procedure of the state in which the district court is held."

(7) Section 719 of the California Code of Civil Procedure (adopted by reference in said Rule 69(a)), reads as follows:

> "The judge, justice, or referee may order any property of the judgment debtor, not exempt from execution, in the hands of such debtor, *or any other person,* or due to the judgment debtor, to be applied toward the satisfaction of the judgment; but no such order can be made as to money or property in the hands of any other person or claimed to be due from him to the judgment debtor, *if such person claims an interest in the property adverse to the judgment debtor or denies the debt.*" (Emphasis supplied.)

II. Jurisdiction of this court is based upon the following:

(1) Section 24 of the Bankruptcy Act provides that courts of appeals of the United States have appellate jurisdiction in proceedings in bankruptcy.

(2) 28 United States Code, Section 1291, provides that the courts of appeal have jurisdiction on appeals from *final decisions* of the District Courts of the United States.

III. The pleadings necessary to show the existence of jurisdiction consist of the following records:

(a) Cobra's petition for arrangement under Chapter XI of the Bankruptcy Act, and the order of reference to the Referee [R. p. 3].

(b) The Referee's findings and order awarding Cobra $6,254.25 [R. p. 7] and the judgment of the District Judge affirming said findings and order [R. p. 4].

(c) Execution against Aircraft and the return by marshal of *nulla bona* [R. p. 7].

(d) The orders of the District Judge directing Coffman's examination, and appointing and directing the Master to conduct Coffman's examination, and to make findings of fact and conclusions of law [R. pp. 30, 31].

(e) Master's original and supplemental reports [R. pp. 47, 80].

(f) Order of District Judge adopting and approving the Master's original and supplemental reports [R. p. 123].

IV. The facts disclosing the basis of the jurisdiction of the District Court and of this Court on appeal are set forth in the Master's original and supplemental reports, adopted and approved by the District Judge.

Appellee's Statement of the Case.

It is to be regretted that appellant's version of the factual situation is faulty and slanted, and is based on fragmentary portions of Coffman's oral testimony, which was inherently improbable and unrealistic and impeached by the documentary evidence, and which the Master rejected as fantastic and in collision with the truth.

We respectfully submit that the truth of the factual situation, stripped from appellant's labored and strained inconsistencies, is fairly depicted in the Master's original and supplemental reports. We beg leave to adopt said reports as the appellee's statement of the case, with the following additions:

I.

Bearing on the incredibility of Coffman's oral testimony in regard to the transfer of his stock to a man under the name of E. E. Brown, the following from his testimony is worthy of note:

(1) On pages 132 and 139 his testimony was (a) that "I *gave* him my stock when he was—when he came in and took charge of it."—"I sold him by stock"; (b) that no record of the transfer was made on the corporate records, and (c) *that the stock was not transferred to Brown, and "the stock remained in my name."*

(2) On pages 133 and 134 his testimony was that he *"handed"* his stock to Brown, but the stock has remained in his name since January 17, 1945.

(3) On pages 147 to 153 he again testified that he *"gave"* his stock to Brown, and that he did at the same time resign as President and Director of the Company, which was *in the latter part of 1945 or in the latter part of 1946.* It is an undisputed fact that the claimed resignation was not recorded on the records of the Company. The exhibits show that Coffman, his wife and his attorney, Rollinson, were at all times the only directors and officers of the Company.

(4) On pages 159 to 166 Coffman's testimony was that he did not at any time deliver his stock to Brown, but he had deposited 100 shares of his 150 shares with his auditor, Mapes (since deceased), and said deposit with Mapes *was to become effective as if, and when Brown had accumulated sufficient working capital.* Coffman further testified that he did not know when the transfer became effective, that he (Coffman) was connected with the Company as late as September, 1946, that Brown did not put any of his own money into the Company, and that Brown had been somewhere in the east for the past several years.

(5) On page 237 Coffman again admitted that the stock was at no time transferred to Brown.

(6) It was admitted by Coffman that Brown's name nowhere appeared in the corporate records either as a stockholder, or as an officer, or director. The fact that Coffman was at all times the majority stockholder, president and director of the Company was established by the documentary evidence, which under Sections 1829 and 1837 of the California Code of Civil Procedure, constitutes the best evidence.

The Master's subsidiary finding in respect to the alleged transfer of his stock appears on page 86 of the record, which is as follows:

> "The vague and uncertain explanation of this transfer of stock in the Aircraft Company and Coffman's resignation from the board of directors is entirely uncorroborated and is directly contradicted by the record evidence heretofore referred to as well as by the conduct of Coffman in retaining control over the affairs of the Aircraft Company. Even assuming that some transaction of the character described by Coffman had taken place, in the opinion of the master, it would not constitute a bona fide transfer of Coffman's stock in the corporation. At most it could be considered as a contemplated transfer of stock which the records of the corporation show did not take place. The testimony of Coffman in this respect lacks credibility and cannot be accepted by the master in giving the legal effect that Coffman ascribes to it. For the foregoing reasons, the master found in his original Findings that Coffman is the dominant and controlling stockholder of the Aircraft Company as well as its president."

II.

Bearing on the lack of the integrity of Coffman's books of account (which are before this court as an exhibit), and bearing specifically on the integrity of the bookkeeping entries therein covering his alleged loans and advances to the Company on which he predicates his offset against the Company, the following may be noted:

(1) When he was interrogated as to the sources of his finances Coffman testified: (a) that he did not know what his annual income was; and (b) that he believed that he had a personal bank account in the Hollywood State Bank and the Bank of America, but he did not know the amount—whether it was $100.00, or a thousand dollars, or as high as fifteen thousand dollars.

The record shows that his individual records were not produced by him in response to the subpoena which was served on him prior to the hearing, and he did not make an effort at any time to locate said records. Coffman further testified that *"If I did have such records* they have long since been disposed of" and that he believed that he had no records of his individual bank account [R. pp. 224-233].

(2) On page 219 Coffman testified that he was a stockholder of Douglas Oil and Sales Company, and on page 223 he testified that no such corporation was in existence, and that he was not a stockholder thereof [See also Ex. 8, which was admitted in evidence without objection].

(3) On page 224 Coffman testified that he was a director of a corporation under the name of Wings, Incorporated, and on page 254 he testified that the Wings company was a partnership consisting of his daughter

and two other parties, and that he had no financial interest in said partnership.

(4) When he was further interrogated as to the sources of his finances, Coffman stated "I would have to look up the records" [R. p. 224]. As heretofore pointed out, his testimony was that all of his records, *if he had any,* had been disposed of.

The master's subsidiary finding on this issue appears on pages 91-93 of the Record, which was as follows:

> "In connection with the account of H. J. Coffman dba Nash Wilshire on the books of the Aircraft Company, No. 99-6, referred to as Exhibit B attached to Coffman's exceptions to the original report and findings of the master, the master found in his original report and findings that Coffman did not deny his indebtedness to the Aircraft Company in the sum of $9,240.46 in good faith and has heretofore made a supplemental finding to the effect that Coffman is not a creditor of the Aircraft Company in the sum of $12,207.39 as would appear from said account. As was previously stated, the master has made these findings for the reason that the account lacks integrity. For instance, the account contains many payroll entries in 1946, a time long after the Aircraft Co. ceased active business. It is difficult to see how these items could be charged legitimately against the Aircraft Company. In addition there is the entry of December 31, 1946, concerning 'Bldg. Arts Center.' This enterprise had no connection with the Aircraft Company, nor did American Vendors, an enterprise in which Coffman was privately interested.
>
> There also appears an entry in said account of October 31, 1947, showing a credit to Coffman in

a substantial amount, which is actually a transfer of 'Wings, Inc., Inter-Company Account,' which account is numbered 99-1 in the ledger of the Aircraft Company. 'Wings, Inc.,' was not a corporation, but a partnership in which Coffman's daughter had a one-third interest [Tr., Vol. 2, pp. 11-12].

In view of the foregoing discrepancies, the master could not in good conscience place reliance on the account submitted by Coffman as an off-set. This view is further substantiated by the testimony of Albert Boris Silverman, public accountant [Tr., Vol. 2, p. 22], to the effect that the records of the Aircraft Company show that the Aircraft Company had been paying Coffman's bills as submitted by him to it.

Assuming that the items contained in Exhibit B are legitimate items, the master is of the opinion that under the decision of Pepper v. Litton, *supra,* and other cases cited, Coffman, as president, director and dominant stockholder of the Aircraft Company, may not claim an off-set against property held by him in trust and which he had misappropriated. To permit him to do so would be to allow Coffman to place himself in the position of a preferred creditor of the Aircraft Company, a practice specifically condemned in the cases cited."

III.

Bearing on Coffman's assertion that he had an interest in the lease covering Aircraft's business place, it should be noted that Coffman's testimony was as follows:

(a) That he signed the lease as an endorser because the landlord made him "go on the lease";

(b) *That the lease was the property of the Corporation;* and,

(c) That the lease was not assigned to him by the Corporation.

Bearing on Coffman's assertion that the property of the corporation was remodeled with his own money, and that it was remodeled in order to enable Aircraft to conduct thereat its corporate business, reference is made to the following subsidiary finding of the master, appearing on page 88:

> "At the time Coffman opened the Nash Wilshire agency, he expended approximately $6,123.76, at least part of which Coffman admitted belonged to the Aircraft Company in renovating the leased premises occupied by the Aircraft Company in order that the premises might be used as an automobile show room for Nash Wilshire, Coffman's personally owned business."

IV.

Without elaborating further on the fictional character of Coffman's offset (which was the central issue involved in the proceeding before the master) it suffices to point up the fact that the subject of his claimed offset was advanced by Coffman for the first time about four months after the proofs had closed, and that this claim was advanced not by sworn testimony, but by an *ex parte* communication [R. p. 39].

As stated by the master in his original report at pages 51 and 52:

> "The master has considered all of the evidence in this matter and has studied the arguments presented by both Cobra and Coffman. It is not considered

appropriate to unduly prolong this report by attempting to set forth an analysis of the evidence presented. The master is of the opinion that the evidence supports the contentions of Cobra, the judgment-creditor. The denial of the debt advanced by Coffman *for the first time in his Memorandum Brief* is not believed to be in good faith, but is urged as an afterthought, no evidence on the point having been offered by Coffman at any of the hearings in spite of notice to the effect that Cobra intended to offer evidence to the effect that Coffman was indebted to the Aircraft Company."

Summary of the Evidence.

In brief summary, the documentary evidence and the realities of the factual situation establish the following facts:

1. That Aircraft was a wartime Aircraft Corporation engaged in war work under contracts with the United States Army; and since the early part of 1945 the corporation was at all times a family corporation consisting of Coffman and his wife and daughter.

2. That Coffman was not only the majority stockholder and president of the corporation, but he was factually and realistically in full and unlimited charge of its business operations, property and assets; and the alleged transfer of his stock to Brown lacks substantiality.

3. That upon the termination of the war hostilities with Germany in the early part of 1945, the operations of the corporation were slowed down, and upon the subsequent termination of the war hostilities with Japan in

August, 1945, the operations of the corporations were stopped completely, and *in October, 1945,* the war business of the corporation was closed for all practical purposes.

4. That Aircraft's net worth in October, 1945, was in excess of $20,000.00, and Cobra at said time was a creditor of the corporation.

5. That Aircraft was not dissolved; and without notice to Cobra, its assets were transferred in October, 1945, by Coffman to his new personally conducted venture, the Nash-Wilshire.

6. That Aircraft's property was used by Coffman in connection with his Nash-Wilshire business and over $6,000.00 in cash was withdrawn by him from Aircraft's funds, commencing with October, 1945, and same were used by him in the conversion of the Aircraft's plant into a building suitable to his Nash-Wilshire business.

7. That Aircraft's moneys, property and assets were later commingled by Coffman with some other assets which the Nash-Wilshire acquired since October, 1945, and by and through Coffman's use of Aircraft's assets, the Nash-Wilshire realized substantial profits, its net worth in 1948 having reached a sum much in excess of $100,000.00.

8. That in addition thereto, over $9,000.00 was withdrawn by Coffman from Aircraft's funds October, 1945, and June, 1948.

ARGUMENT.

Appellee prefaces its reply to appellant's several contentions with these preliminary observations:

I.

Under the modern law, established by the decisions since the decision of the United States Supreme Court in *Alexander v. Hillman* (296 U. S. 222, 56 S. Ct. 204, 80 L. Ed. 192) was handed down, the referee had the jurisdiction and power to make and enter the *affirmative* order on Cobra's set-off under Section 68 of the Bankruptcy Act, and the order of the referee [R. pp. 5-11] was valid and enforceable. Moreover, no motion to vacate said order was made by Aircraft or Coffman pursuant to Rule 60 of the Federal Rules of Civil Procedure. Also, this point was at no time raised in the court below, either in the bankruptcy proceeding or in this proceeding. It is raised by the appellant for the first time on this appeal, and it is not open for review.

II.

Bankruptcy courts have equitable jurisdiction and legalistic formalism is not required in the framing of their orders and decrees. It is sufficient that the order of the bankruptcy court should adjust the relief sought in a manner that is just and equitable and affords protection to the rights of the parties, and finally determines the rights and claims of the parties relating to the subject matter involved. The order of the referee was based on Section 68 of the Bankruptcy Act, and it did finally determine and adjudicate the rights of the parties. This order was an appealable order and was a judgment under Rules 54 and 79 of the Federal Rules of Civil Procedure and under the California Code of Civil Pro-

cedure. The contrary contention of the appellant was not raised by him either in the bankruptcy proceeding, or in the instant proceeding. It is raised by him for the first time on this appeal, and same is not open for review.

III.

The contention of the appellant that the order of the referee was not a valid and enforceable judgment, likewise was not raised in the appellant's exceptions to the master's original and supplemental reports as required by Rule 53 of the Federal Rules of Civil Procedure. For this further reason appellant's contention is not open for review.

IV.

It was stipulated by the parties in open court [see Order of Re-reference, p. 77] that the issues before the master were limited to a determination of the factual and legal validity of appellant's asserted offset, and the jurisdiction of the master to make an adjudication of this issue was not challenged by the appellant in his exceptions to the master's supplemental report [R. p. 96].

V.

It was admitted by appellant at the hearing of his exceptions to the original report of the master that he was in fact indebted to Aircraft in the sum of $9,240.46, same representing his withdrawals from Aircraft as found by the master. The master's factual finding that appellant was not entitled to his offset and that the denial of his indebtedness in the aforesaid sum of $9,240.46 was not made by him in good faith, is based on substantial evidence. Under Section 719 of the California Code

of Civil Procedure the master, as trier of the facts, had jurisdiction and power to pass upon the bona fides of appellant's offset, and his finding is binding on this court. The master's finding was also concurred in by the district judge.

VI.

Cobra's claim against Coffman was based on the Fraudulent Instruments and Transfers Act, Sections 3429 to 3439.11 inclusive of the Civil Code of the State of California. It cannot be denied that Aircraft was Cobra's debtor within the meaning of Section 3429, Civil Code; that Cobra was a creditor of Aircraft within Sections 3430 and 3439.07, Civil Code; that Aircraft ceased to do business in the summer of 1945, at which time Cobra was a present as well as a future creditor of Aircraft within the meaning of Section 3439.06, Civil Code; that in October, 1945, Aircraft had assets in the approximate amount of $20,000.00 and said assets were taken over by Coffman without payment therefor and Aircraft was thereby rendered insolvent; that Coffman's misappropriation of Aircraft's assets was a fraud on Cobra within the meaning of Sections 3439.04 and 3439.05 of the Civil Code; that Coffman, as the dominant stockholder, director and president of Aircraft, held the Aircraft's assets in trust for the benefit of Aircraft's creditors, had no legal or equitable right to misappropriate said assets for his own benefit in fraud of Aircraft's creditors.

All of the foregoing facts were conclusively established by the documentary evidence and as stated by this Court in *Heath v. Helmick,* 173 F. 2d 157, "it should have been error for the referee to have found otherwise."

I.

The Order of the Referee Under Section 68 of the Bankruptcy Act Affirmed by the District Judge Under Section 39(C) of the Bankruptcy Act Made a Final Binding Determination of the Rights and Claims of the Parties. It Is a Valid Judgment in Equity for the Payment of Money in a Definite Amount Which Is Enforceable by Execution.

A.

In support of his contention that the referee was without jurisdiction to render an affirmative judgment on Cobra's counterclaim and set-off, counsel for appellant cites, on page 14 of his brief, three early decisions rendered by the District Court of California prior to the adoption of the Federal Rules of Civil Procedure. It is evident that counsel for appellant did not study the law on this subject, and failed to note that the law laid down in these three early decisions has been rejected as unsound in the recent decisions rendered after the adoption of the Federal Rules of Civil Procedure. The recent cases on this subject are:

Florence v. Kresge (C. A. 4), 93 F. 2d 784;

In re Solar Manufacturing Co. (C. A. 3), 200 F. 2d 327;

Floro Realty Co. v. Stem Electric Co. (C. A. 8), 128 F. 2d 338;

Griffin v. Vought (C. A. 2), 175 F. 2d 186;

Columbia Foundry v. Lochner (C. A. 4), 179 F. 2d 630;

In re Nathan (D. C. Cal), 98 Fed. Supp. 686.

We direct specific attention to the *Nathan* case (98 Fed. Supp. 686) in which Judge Mathes in his opinion

rendered on June 28, 1951, made a scholarly and illuminating exposition of the law on this subject, and also to the opinion of the Third Circuit in *In re Solar Manufacturing Co.* (200 F. 2d 327) wherein the Appellate Court for the Third Circuit has approved the decision of Judge Mathes. For the benefit of the Court we cite *in extenso* from the *Nathan* case and from the *Solar Manufacturing Co.* case in the appendix. See also the summary of the law laid down by Collier, which is set forth in full in the appendix.

It is now well settled that the referee had jurisdition to make the order. It is singular that these recent decisions are not cited in appellant's brief, albeit they were readily accessible. It is to be noted further that appellant's present contention was not raised in the court below, either in the original bankruptcy proceedings, or in the instant supplementary proceeding, and it is raised for the first time by the appellant on this appeal.

B.

The order of the referee in question, affirmed by the district judge on appellant's petition for review under Section 39(c) of the Bankruptcy Act, made a final determination of the rights and claims of the parties. Said determination was *res adjudicata* (*In re Nathan, supra*) and constituted a judgment in equity under Rules 54 and 59 of the Federal Rules of Civil Procedure and under Section 577 of the California Code of Civil Procedure, which states that "A judgment is the final determination of the rights in an action or proceeding."

It constitutes a judgment also under Section 1060 of the California Code of Civil Procedure, which states

that "a declaration" made by the Court of the rights of the parties "shall have the force of a final judgment."

It requires no argument that archaic legalistic formalism in pleadings that was adhered to in Blacktone's era is not recognized at this date under the American system of jurisprudence. This is especially true in equity cases, and it is not required that the court frame its judgments and decrees in accord with legalistic formalism. It is sufficient that the judgment makes a final determination of the rights and claims of the parties.

30 C. J. S., Sec. 599, p. 986;

10 Cal. Jur., Sec. 96, p. 559.

A judgment is to be judged from its *substance,* rather than from its form, and it is a final judgment if it declares the rights of the parties in accordance with the findings of the court.

Hamilton Corp. v. Corum, 218 Cal. 92.

In support of his contention that the order of the referee in question did not constitute a judgment, appellant's counsel again relies on the case *In re Continental Producing Co.,* 261 Fed. 627 (App. Br. pp. 14, 15), which has been disapproved and rejected by the recent decisions; moreover the statement in said case (which appellant italicized and reading "The net result is that, though the finding of the referee with respect to the counterclaim of the trustee does not, in form, constitute a judgment against the creditor" was only a dictum.

Comments on Appellant's Other Citations.

Bank of America v. Standard Oil Co., 10 Cal. 2d 90, on page 15 of Appellant's Brief. In this case the Court ruled that no execution could issue for the reason that the judgment there *did not make a final determination of the parties, and for the further reason that the indebtedness due was not stated in a definite amount.* Such is not our case.

Wellborn v. Wellborn, 55 Cal. App. 2d 516, cited on page 16 of Appellant's Brief: This case involved an annulment of marriage and the Court stated that no execution could issue for the reason that *"there was no personal judgment for this amount, nor was there anything in the nature of a personal judgment."* This statement of the Court is omitted in Appellant's Brief.

Hennessey v. Puertas, 99 Cal. App. 2d 151, cited on pages 16 and 17 in Appellant's Brief: The judgment in that case provided that plaintiff was entitled to rents at the rate of $75.00 per month "subject to the terms of the lease." The judgment there was a qualified and conditional judgment, and not an unconditional judgment for payment of money in a definite amount such as due here.

McKay v. Coca-Cola Bottling Co., 110 Cal. App. 2d 672 (243 P. 2d 135), cited by appellant on page 17 of his brief. This case involved the enforcement of arbitration award and the judgment went no further than the approval of the arbitration award, and as stated by the Court on page 677 of its opinion, "It is thus clear that

the money due could not be determined from the judgment."

We respectfully submit that appellant's citations have not the remotest application to the case at bar. In the case at bar the order of the referee made a final determination of the rights and claims of the parties, and the indebtedness therein, from Aircraft to Cobra, was in the definite amount of $6,254.25. [R. p. 11.] It is clear that the order of the referee constituted an absolute and unconditional judgment for payment of money in a definite amount, and it was enforceable by execution under Section 684 of the California Code of Civil Procedure.

Pirta v. Rosetar, 205 Cal. 197, 200;

Asakian v. Dusenberry, 15 Cal. App. 2d 55 (in which a writ of mandate was issued to compel the issuance of an execution);

Welch v. Reese, 82 Cal. App. 27, 28.

In the *Pirta v. Rosetar* case (205 Cal. 197) the court stated at page 200 as follows:

> "Conceding the finality of said interlocutory decree, respondent nevertheless questions the sufficiency of the wording of the clause which finds due, owing and unpaid from respondent to appellant said sum of $9,840 to constitute a valid award. * * * In substance is decrees to appellant from respondent said sum * * * The form of the judgment is of no consequence so long as it may be ascertained therefrom what rights, if any, of the respective parties in the

action have been determined by the court. The test of its sufficiency must rest in its substance rather than its form." (Citing cases.)

See also the following from *Security Trust and Savings Bank v. So. Pac. R. R. Co.*, 6 Cal. App. 2d 585, 588-589:

"It is a well established principle of law that a court possesses inherent power to enforce its judgments. (Citing cases.) Section 128 of the Code of Civil Procedure provides in part: 'Every court shall have power . . .

" '4. To compel obedience to its judgments, orders and process . . . in an action or proceeding therein. . . . Every court has inherent power to enforce its judgments and decrees and to make such orders and issue such process as may be necessary to render them effective. . . . The power to enforce their decrees is necessarily incident to the jurisdiction of courts. Without such power, a decree would in many cases be useless. All courts have this power and must necessarily have it; otherwise they could not protect themselves from insult or enforce obedience to their process. Without it they would be utterly powerless."

It should be noted that this point was not raised by the appellant in the court below, either in the original bankruptcy proceedings or in the instant supplementary proceedings, and it is raised for the first time on appellant's present appeal.

II.

The Master Had Jurisdiction and Possessed Judicial Power to Make the Factual Determination That Coffman's Denial of His Indebtedness to Aircraft Was Fictitious and Was Not Made in Good Faith.

Appellant's contention that the master was bound to accept Coffman's incredible testimony at its face value, and to ignore the realities of the factual situation, and all of the documentary evidence, is clearly without merit.

We respectfully invite the Court's attention to the case of *Parker v. Page,* 38 Cal. 522, referred to in the forepart of this brief, which case we respectfully submit, is a conclusive answer to appellant's contention.

It is respectfully submitted that the master's supplemental report clearly indicates that he has taken into consideration all of the evidence, including all of the documentary evidence, offered by the parties, and that he has taken exceptional pains to make a careful examination of all of the entries contained in the books of account of the Aircraft Company. We respectfully submit that on the basis of the evidence, the Master was justified in stamping Coffman's conduct as fraudulent, and that Coffman has in his possession the Aircraft's property, which he should turn over to Cobra pursuant to Section 719 of the California Code of Civil Procedure.

We respectfully submit that the Master was justified to make the following factual determination:

Under Rule 53(e)(2) of the Rules of Civil Procedure the master's findings are conclusive, unless clearly erroneous. (See cases cited in footnote below.)*

The factual findings of the master were also concurred in by the District judge. See *Heath v. Helmick,* 173 F. 2d 157, where this Court stated that the findings of the referee when concurred in by the trial court on review are binding on the appellate court, and that it would have been error for the trial judge to reject the master's findings on the facts therein involved, which we respectfully submit were for all practical purposes identical with the factual situation herein involved.

III.

Coffman Occupied a Fiduciary Relationship to Aircraft's Creditors and Was Bound to Act in the Utmost Good Faith.

In addition to the authorities cited in the appendix we submit the following authorities:

Hanson v. Cheynski, 180 Cal. 275, 285;

In re Los Angeles Lumber Products Co., 46 Fed. Supp. 77, 88;

California Corporations Code, Secs. 825, 826;

Ballantine and Sterling's California Corporations Code (1949 Ed.), par. 151, pp. 210, 211; par. 152, p. 211; par. 153, p. 213; par. 155, p. 215; par. 161, p. 219, and par. 167, p. 229.

**Arrow Distilleries, Inc.* (Michigan) *v. Arrow Distilleries, Inc.* (Illinois), 117 F. 2d 636, cert. den., 314 U. S. 633, 86 L. Ed. 508, 62 Sup. Ct. 67; *Stewart v. Ganey,* 116 F. 2d 1010; *Santa Cruz Oil Corp. v. Allbright-Nell Co.,* 115 F. 2d 604; *In re Connecticut Co.,* 107 F. 2d 734; *National Labor Relations Board v. Arcadia-Sunshine Co., Inc.,* 132 F. 2d 8; *Olds v. Rollins College,* 173 F. 2d 639; *In re Kelly,* 85 Fed. Supp. 316; *In re Kellett Aircraft Corporation,* 85 Fed. Supp. 525.

IV.

It Was Coffman's Statutory Duty to Have Aircraft Dissolved and to Pay Its Debts and Distribute Its Assets Upon the Termination of the War Under the California Corporations Code. In the Absence of Such Dissolution Coffman's Misappropriation of the Aircraft's Assets Was Wrongful, and He Held Same in Trust for Cobra.

In addition to the case of *Saracco Tank and Welding Co. v. Platz,* 65 Cal. App. 2d 306, quoted from *in extenso* in the appendix, see also Sections 4600 to 4619 of the California Corporations Code, which govern dissolution of corporations, and Section 4607 of the Corporations Code which requires that the distribution of the corporate assets be had under the supervision of the court. Sections 4608 to 4619 also prescribe the procedure for filing of claims by creditors against the corporation, and for the determination by the court.

This was not done by Coffman. It is clear that Coffman cannot, as a matter of fact and law, claim title to Aircraft's property, monies and assets, which the record shows amounted to over $20,000.00 in October of 1945. Nor did he have the legal or equitable right to withdraw from Aircraft's funds in excess of $9,000.00, which the master found Coffman had withdrawn from the treasury of the corporation between October, 1945, and June, 1948.

It is clear that pursuant to Section 719 of the California Code of Civil Procedure Cobra is entitled to an order ordering Coffman to pay over to Cobra the amount of its unpaid judgment, with interest and costs, and that such an order may be enforced pursuant to Section 721 of the Code of Civil Procedure.

In re Meyers, 46 Cal. App. 92.

V.

The Order Requiring Coffman to Make Restitution Was Proper.

This order, as above stated, conformed to Section 719 of the Code of Civil Procedure, and same is enforceable against Coffman personally under Section 721 of the Code of Civil Procedure. It is to be noted that Section 719 of the Code of Civil Procedure covers two situations: (1) When the property is in the possession of a third party, or (2) When the third party is indebted to the judgment debtor. Both said factual situations are present in this, case, either on the theory that Coffman is holding Aircraft's property in trust, or on the theory that he is indebted to Aircraft irrespective of a trust relationship for the reason that he had no right to misappropriate Aircraft's property without accounting for its proceeds and its disappearance under the Fraudulent and Transfers Act referred to in the forepart of this brief.

As stated in 12 American Jurisprudence, page 438:

> "Where an alleged contemner has voluntarily and contumaciously brought on himself disability to obey an order or decree he cannot avail himself of a plea of inability to obey as a defense to a charge of contempt."

See also Annotation in 120 A. L. R., page 704.

The case of *Farmers and Merchants Bank v. Bank of Italy,* 216 Cal. 452, cited by appellant on page 27 of his brief, has not the remotest application or relevancy to the present issue. The point under discussion was not even touched upon by the court. The holding of this case was only to the effect that the court would have no power

to order a third party to turn over his property to the judgment debtor under Section 719 of the California Code of Civil Procedure *if, as and when the third party denied his indebtedness in good faith.* Such is not the case here. The master found on substantial evidence that Coffman's denial of his indebtedness was not made in good faith, and that he, as trustee for Cobra, should account for the disposition of Aircraft's assets.

The case of *Knutte v. Superior Court,* 134 Cal. 660, 66 Pac. 875, cited by appellant on page 30 of his brief, involved the question whether the refusal by a tenant *to pay rent* subjected him to contempt. The court held that payment of rent constituted a debt, and that payment thereof is not enforceable by contempt. We fail to see the relevancy of this case.

Conclusion.

For sake of economy of space and time we confined our comments on appellant's brief to only a few of the appellant's inaccurate statements. We earnestly believe that the precise picture of the case, stripped from irrelevancies, is cogently presented in the master's findings which are abundantly supported by the record.

We respectfully submit that appellant's appeal is devoid of merit, and the order appealed from should be affirmed.

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Joseph B. Beckenstein,
Attorneys for Appellee.

APPENDIX.

In re Nathan, 98 Fed. Supp. 689, Judge Mathes stated:

"Divergent opinions have been expressed in both this and other circuits on the question of whether in summary proceedings upon the claim of a creditor, a bankruptcy court, Bankruptcy Act, Sec. 1(9), 11 U. S. C. A., Sec. 1(9), has jurisdiction to award affirmative relief upon the trustee's counterclaim for a preference received by a claimant. (Citing cases.) . . .

Generally speaking it is settled that 'A creditor who offers proof of his claim, and demands its allowance, subjects himself to the dominion of the court, and must abide the consequences.' (Citing cases.)

Thus the trustee at bar was entitled to assert any defenses against the claim, including a setoff based upon a preference received by the creditor; and the court have held that the bankruptcy court has jurisdiction summarily to adjudicate the merits of the alleged setoff.

The rationale of this holding is that 'One who has presented proof of debt had submitted his claim to the jurisdiction of the bankruptcy court, and must be deemed to have consented to the jurisdiction of that court to decide any defense that may be lawfully interposed.' (Citing cases.) . . .

So the ultimate question here is whether there exists rational basis to extend the rule of Alexander v. Hillman, *supra*, 296 U. S. 222, 56 S. Ct. 204, 80 L. Ed. 192, to imply consent for the bankruptcy court summarily to

adjudicate the counterclaim for a preference and, if proper, to render an affirmative judgment against the claimant thereon. . . .

I am of the opinion that there is rational basis for finding implied consent that the bankruptcy court exercise summary jurisdiction to adjudicate and render affirmative judgment on a counterclaim to recover a preference; and this result is reached by means of the traditional common-law technique of reasoning by analogy from recognized legal principles. . . .

Hence the bankruptcy court would be called upon to determine summarily the merits of the counterclaim as a defense or setoff to the claim. (Citing cases.) And such determination when final would be *res judicata* between the creditor and the trustee. (Citing cases.) . . .

The legal result being in substance the same as if actual consent had been given, there exists a rational and solid ground for holding that a creditor, by presenting his claim for examination and allowance, Bankruptcy Act, Sec. 57, 11 U. S. C. A., Sec. 93, impliedly consents to adjudication by the bankruptcy court in summary proceedings, Bankruptcy Act, Sec. 23b, 11 U. S. C. A., Sec. 46b, of not only the merits of the claim and of any defenses or setoffs thereto, see Giffin v. Vought, *supra,* 175 F. 2d at page 190, but also the merits of any counterclaim for affirmative judgment which the trustee may properly assert in response to the claim . . . (citing case).

In addition to the considerations of reason just discussed there are patent considerations of policy which also support extension of the rule of Alexander v. Hill-

man, *supra,* 296 U. S. 222, 56 S. Ct. 204, 80 L. Ed. 192, to bankruptcy proceedings.

The general policy of the Bankruptcy Act to effect 'quick and summary disposal of questions arising in the progress of the case, without regard to usual modes of trial attended by some necessary delay' Bailey v. Glover, 1874, 21 Wall. 342, 88 U. S. 342, 346, 22 L. Ed. 636, is supplemented by the provisions of Sec. 68, sub. a, 11 U. S. C. A., Sec. 108, sub. a, which in effect declare a statutory policy to settle all permissible claims or accounts 'between the estate of a bankrupt and a creditor.' (Citing cases.)

The provisions of Rule 41 of the Federal Rules of Civil Procedure, applicable in bankruptcy, clearly further such a policy. (Citing cases.)

Thus the same considerations of reason and policy which support the holding that filing of a claim gives consent of the creditor to adjudication of an affirmative judgment on equitable counterclaims in a plenary suit (citing cases), also support the holding that filing of a claim in bankruptcy gives the consent necessary to confer jurisdiction upon the bankruptcy court to adjudicate counterclaims for preferences, both legal and equitable, compulsory or permissive. (Citing cases.)

As Mr. Douglas put it in Case v. Los Angeles Lumber Products Co., 1939, 308 U. S. 106, 126-127, 60 S. Ct. 1, 12, 84 L. Ed. 110: 'And once the jurisdiction of the court has been invoked, whether by the debtor or by a creditor, that petitioner cannot withdraw and oust the court of jurisdiction. He invokes that jurisdiction risking all of the disadvantages which may flow to him as a consequence, as well as gaining all of the benefits.' "

In re Solar Manufacturing Corporation, 200 F. Rep. 2d, the court stated at page 329:

"Prior to Alexander v. Hillman, 1935, 296 U. S. 222, 56 S. Ct. 204, 80 L. Ed. 192, the pertinent law generally was that although a bankruptcy court could consider defenses to claims filed against the bankrupt estate and was empowered to set off any claims of the estate against the claimant up to the amount of the claim, it was without jurisdiction to render an affirmative judgment against the claimant, absent the latter's consent to jurisdiction. In the Hillman opinion the Supreme Court held that former officers of a corporation in receivership who had filed claims with the equity receiver, but who had not been served with process, subjected themselves to the jurisdiction of the district court for the purposes of counterclaims based on their alleged misappropriations. The court noted that since the subject matter of the counterclaims, like the claims, was cognizable in equity the district court had jurisdiction to grant affirmative relief.

The reasoning of Hillman was thereafter applied to bankruptcy cases. In Florance v. Kresge, 4 Cir. 1938, 93 F. 2d 784, it was decided that an unsecured creditor who had filed a proof of claim and a petition of intervention submitted himself to the jurisdiction of the court for purposes of a counterclaim which arose out of a contract between claimant and bankrupt and was asserted by the receivers and trustee. The court did not characterize the counterclaim as either equitable or legal, although it seems to have been the latter. The Fourth Circuit in Columbia Foundry Co. v. Lochner, 1950, 179 F. 2d 630, 14 A. L. R. 2d 1349, held that a corporation which had filed a proof of claim based on goods sold and delivered and had

voted at the first meeting of creditors subjected itself to the trustee's counterclaim for a breach of warranty. There also the counterclaim was legal in character."

After citing *In re Nathan* and other cases, the court continued at page 331 as follows:

". . . We are in accord with the Nathan opinion that the Hillman rule should be extended to cover situations like the one before us. We hold that Marine subjected itself to the court's summary jurisdiction respecting the counterclaims when it filed its account and proofs of claim. . . ."

In *Collier on Bankruptcy,* 14 ed., it is stated on page 790 (see Supplement):

"One who files a proof of claim should be held to acquiesce in the adjudication of any proper set-off or counterclaim even to the extent of a judgment thereon, since as pointed out in the *Kresge* case, the claimant puts himself in a position, should his interests warrant, to challenge the receiver's or trustee's acts and the demands of others claiming as creditors. He should not be permitted to claim the benefits of such a position, and yet maintain a favored advantage as against the trustee or receiver, compelling that officer to resort to a plenary action to collect on a claim that is a proper subject of set-off or counterclaim."

In *Nixon v. Goodwin,* 3 Cal. App. 358, the court said on pages 363 and 364 as follows:

"The rule is that a director of an insolvent corporation cannot receive to himself any preference or advantage over other creditors in the payment of his debt (Bonney v. Tilley, 109 Cal. 346 (42 Pa. 439)); and surely the same rule would apply with equal force to one who is a large

creditor of the corporation of which he is a director and the president, and who resigns today that he may tomorrow (secretly as to all other creditors) accept a conveyance to himself of the corporation's property.

Nor would such a transfer coming under the provisions of Section 3452 of the Civil Code, where a debtor may pay one creditor in preference to another, or may give one creditor security for the payment of his demand in preference to another, because such action, when taken by a director, or one so lately holding that relation, would be taking an unfair as well as unlawful advantage of other creditors, and would be an attempt pure and simple to prevent a ratable distribution of the insolvent's assets among his creditors. The defendant does not stand as an ordinary common creditor; for, notwithstanding his resignation as director and president for the purposes for which tendered, he cannot escape the conclusion inevitably to be reached that he stands still in the same light the law views a director of a corporation when it forbids him making himself a preferred creditor, and any attempt at so doing, in our opinion, would subject him and his acts to the same prohibition as though he were still a director. A man cannot be permitted to so easily throw off his trust relations, and, as here, for the purpose of giving him an advantage over ordinary creditors, that he may take the property which he as a director has been holding in trust for all the creditors and apply it on his own debt to their detriment."

In *Title Ins. Co. v. California Dev. Co.,* 171 Cal. 173, the court said on pages 206, 207:

"Directors and officers of a corporation occupy a relation to other creditors 'demanding the utmost good

faith on their part in the handling of the corporation assets. * * * ' * * * 'Directors of an insolvent corporation who have claims against the company as creditors,' says Mr. Morawetz (2 Morawetz on Corporations, 2d ed., sec. 787), 'cannot secure to themselves any preference or advantage over other creditors, by using their powers as directors for that purpose.' (Citing cases.) The rule is so firmly established that further citation of authority is unnecessary."

In *Stuart v. Larson,* 298 Fed. 223, the court used the following language on pages 227, 228:

"The courts are not agreed as to the power of directors of insolvent corporation to prefer themselves, and while directors may in good faith, advance money to keep a corporation a going concern and take security therefor, yet the great weight of authority in this country is that the directors of an insolvent corporation, who are also creditors thereof, have no right to grant themselves preferences or advantages in the payment of their claim over other creditors, and such rule is merely applied common honesty. A director occupies a certain fiduciary position toward the stockholders and the creditors. He has better facilities for knowing the condition of the company than have the other creditors, and he ought not to be permitted to use that position to benefit himself at their expense. * * *

In Cook on Stock and Stockholders, section 660, it is said: 'It is a fraud on the corporation and on corporate creditors for the directors to buy up at a discount the outstanding debts of the corporation and compel it to pay them the full face value thereof. In such a case the directors may be compelled to turn over to the cor-

poration the evidence of indebtedness upon being paid the money which they gave for the same.' "

In re the Van Sweringen Company, 119 F. 2d 231, 234, the court said:

"* * * As expressed by Chief Judge Cardozo in Meinhard v. Salmon, 249 N. Y. 458, 464, 164 N. E. 545, 546, 62 A. L. R. 1: 'Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. * * * Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.' "

In *Buffum v. Barceloux Company,* 289 U. S. 277, it is stated:

"As an outcome of these maneuvers the Barceloux Company canceled an indebtedness of about $33,000, and became the owner of stock certificates worth triple that amount. The unconscionable sale is not to be viewed in isolation, as something disconnected from the pledge, an accident or afterthought. It was the fruit for which the seed was planted, or so the trier of the facts might look at it. The Barceloux Company set out to do some-

thing more than secure the payment of a debt. It became a party to a plan to appropriate a surplus and in combination with its debtor to hold his creditors at bay."

In *Pepper v. Litton,* 60 S. Ct. 238, 308 U. S. 295, the court said:

"And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not only in the foregoing types of situations but also where the paid-in capital is purely nominal the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan."

Section 824 of the Corporations Code states:

"Unlawful purchase of shares, declaration or payment of dividends, or withdrawal or distribution of assets. Except as provided in this division, the directors of a corporation shall not authorize or ratify the purchase by it of its shares, or declare or pay dividends, or authorize or ratify the withdrawal or distribution of any part of its assets among its shareholders."

In *Saracco Tank & Welding Co. v. Platz,* 65 Cal. App. 2d 306, plaintiff was the judgment creditor of the Contact Mercury Mines Co., Inc., a Nevada corporation, and the judgment against it has not been satisfied. Thereupon, an action was commenced by the judgment creditor against the directors and officers of the judgment debtor, who had caused the assets of the judgment debtor to be transferred to a California corporation, without dissolution of the debtor corporation and without notice to the judgment creditor. Plaintiff, the judgment creditor, was

awarded judgment against the directors and officers of the judgment debtor corporation for the amount of the unpaid claim. The court declared:

(1a)

"We are of the opinion the findings and judgments are adequately supported by the evidence. The judgment is founded on the statutory liability in favor of creditors and against directors of a foreign corporation doing business with this state, for violation of their official duties in making unwarranted 'distribution of assets,' as provided by section 412 of the Civil Code."

(1b)

"The evidence satisfactorily shows that while the appellant was acting as secretary and as a director of the Nevada corporation, with full knowledge of plaintiff's unpaid claim and of other indebtedness in the aggregate sum of $9,000, he organized a new corporation and participated in the transfer of all property and assets of the foreign corporation to the new Contract Mining Company, leaving the former corporation defunct and insolvent."

(4)

". . . It has been held the directors of corporations are trustees for the benefit of stockholders and creditors. (Winchester v. Howard, 136 Cal. 432, 442 (64 P. 692, 69 P. 77, 89 Am. St. Rep. 153); 6A Cal. Jur. 1100, Par. 620.) In the Winchester case, *supra,* it is said:

"Directors are also trustees for stockholders and indirectly for the creditors. They have always been held responsible as trustees in their management of the property and affairs of the corporation."

(5)

When a corporation becomes insolvent its assets are held in trust for the benefit of the stockholders and creditors. In 15A Fletcher's Cyc. of Corp., perm. ed. (1938), section 7369, at page 59, it is said:

"The theory of the trust fund doctrine is that all of the assets of a corporation, immediately on its becoming insolvent, become a trust fund for the benefit of all of its creditors." * * *

(6)

". . . *The transfer was made without notice to the plaintiff. The original corporation never thereafter transacted business.* That transaction was a clear breach of trust and rendered the directors liable for the loss thereby sustained to plaintiff. *The transfer amounted to a voluntary dissolution of the Nevada corporation, without providing for the payment of all of its debts.* It resulted in a preference of existing creditors. Section 401a of the Civil Code provides that a distribution of assets to the stockholders on dissolution of the corporation may be made only 'after determining that all of the known debts and liabilities . . . have been paid or adequately provided for.' This was not done. The directors are therefore liable for plaintiff's claim." (Emphasis supplied.)